No. 794

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CHARLES ELMORE

IN THE

Supreme Court of the United States

October Term, 1948

THE UNION TRUST COMPANY OF INDIANAPOLIS,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

LUCIEN L. DUNBAR,
925 Circle Tower,
Indianapolis, Indiana,

MERLIN M. DUNBAR,
925 Circle Tower,
Indianapolis, Indiana,
Counsel for Petitioner.

Mark Gray Co., 223 E. Ohio St., Indianapolis

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STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code

Internal Revenue Code, Section 22(b) (12), as added by Section 116 of the Revenue Act of 1942 (56 Stat. 798):

> "Exclusions From Gross Income.—The following items shall be exempt from taxation under this chapter:
>
> "(12) Recovery of Bad Debts, Prior Taxes, and Delinquency Amounts.—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purpose of this paragraph:
>
> "(A) Definition of Bad Debt.—The term 'bad debt' means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.
>
> "(D) Definition of Recovery Exclusion.—The term 'recovery exclusion,' with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludable in previous taxable years with respect to such debt, tax, or amount under this paragraph.

"(B), (C) and (E)" (omitted because here not relevant.)

"Section 29.22 (b) (12-). Recovery of Certain Items Previously Deducted.—(a) In general. Section 22(b) (12) provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. See *Dobson v. Commissioner,* 64 S. Ct. 239. The term "recovery exclusion" as used in these regulations means accordingly an amount equal to the portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in section 22(b) (12), and of all other items subject to the rule of exclusion which when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under chapter 1 of the Internal Revenue Code (other than a tax under section 102) or under corresponding provisions of prior revenue laws.

"(1) Section 22(b) (12) items.—The term 'section 22(b) (12) items' as used in these regulations means those bad debts, prior taxes, delinquency amounts, and all other items subject to the rule of exclusion, for which a deduction or credit was allowed for a prior taxable year. If a bad debt was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts, it was not deducted, and it is therefore not considered a section 22(b) (12) item. Bad debts, prior taxes, and delinquency amounts are defined in section 22(b) (12) (A), (B), and (C), respectively. A typical example of delinquency amount described in that section is interest upon delinquent taxes. A typical example of the other items not expressly referred to in

section 22(b) (12) but nevertheless subject to the rule of exclusion is a loss sustained upon the sale of stock and later recovered, in whole or in part, through an action against the party from whom such stock had been purchased."

REVENUE ACT OF 1932, 47 Stat. 169

"Section 22. Gross Income.

* * *

"(c) Inventories.—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

"Section 23. Deductions from Gross Income.—In computing net income there shall be allowed as deductions:

"(j) Bad Debts.—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such a debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(NOTE: Section 22(c) and 23(k) of the Revenue Act of 1936 are identical with Sections 22(c) and 23(j), respectively, of the Revenue Act of 1932, quoted above.)

"Section 23. Deductions From Gross Income.

* * *

"(k) Bad Debts.—

(1) General Rule.—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection.

* * *

(3) Definition of Securities.—As used in this subsection the term "securities" means bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form."

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

To the Honorable Fred M. Vinson, Chief Justice and the Associate Justices of the Supreme Court of the United States.

The Union Trust Company of Indianapolis prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in the above entitled cause on March 2, 1949, reversing the decision of the District Court of the United States for the Southern District of Indiana.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit rendered March 2, 1949, 173 Fed. (2nd) 54 is found at R. 57-61.

The District Court did not write an opinion in this case. Its findings of fact and conclusions of law (R. 31-41) are not officially reported.

JURISDICTION

This petition is made under Section 240 of the Judicial Code as amended by the Act of February 13, 1925, 43 Stat. 938. The judgment of the United States Court of Appeals was entered on March 2, 1949.

STATEMENT OF THE MATTERS INVOLVED

This case involves the legality under the Internal Revenue Code and the U. S. Constitution of treating as taxable income amounts recovered on bonds under circumstances which establish conclusively that the petitioner had not realized and would not realize any economic gain or tax benefit from the transaction. The bonds here involved consisted of corporate and governmental obligatoins acquired prior to 1939. During the years 1932, 1933 and 1937 under direction of Federal and State supervisory agencies, chargeoffs were made, in part, of said bonds, and deductions therefor taken in petitioner's income tax returns for such years. Petitioner had substantial losses in those years in excess of the chargeoffs and would have paid no income tax had no deductions been taken for the chargeoffs. In 1939 petitioner made recoveries amounting to less than the chargeoffs. Petitioner asserts the right to exclude such recoveries from taxable income under Section 22(b) (12) of the Internal Revenue Code, as added by Section 116 of the Revenue Act of 1942, and under the principle of law laid down by this Court in *Dobson v. Commissioner*, 320 U. S. 489, 64 S. Ct. 239.

STATEMENT OF FACTS

This cause was submitted upon a stipulation of facts uncontradicted oral testimony and exhibits. The District Court made its findings of fact thereon.

The petitioner, a bank as defined under Section 104 of the Internal Revenue Code (R. 32) owned certain bonds which were obligations and debts of corporations, private, municipal and State and of the United States government, all of which were in registered form or had interest coupons attached, acquired by petitioner prior to 1939 and sold or redeemed in 1939 (R. 37). The petitioner kept a security ledger in which it recorded the date of purchase, the description, and the purchase price of each bond and the bad debt charge-offs from time to time which it made on its books by writing down each such bonds pursuant to the demand of the Indiana Department of Financial Institutions (R. 21, 22, 23).

The petitioner has since the year 1921, with the approval of the Commissioner of Internal Revenue, filed its income tax returns upon the inventory basis (R. 32). The bad debt charge-offs were reflected on the books of the petitioner by write-downs, whereas said charge offs were reflected in the petitioner's income tax returns by a reduction of the gross profit (R. 21, 33).

In the years 1932, 1933 and 1937 petitioner took bad debt charge-offs aggregating $26,892.77 which did not affect its income tax liability for such years (R. 37). Petitioner had a loss in each such year and would have owed no income tax for said years even though it had not claimed such charge-offs on its tax returns (R. 35, 37).

In 1939 when the bonds were redeemed or sold, the petitioner reported a profit of $34,055.76 in its income tax return which amount included recoveries of bad debt charge-offs of $22,335.76 taken by petitioner in loss years for which it received no tax benefit (R. 37). On twelve out of

the twenty-two issues of bonds the petitioner actually suffered an economic loss instead of realizing a profit as reported (R. 37). To illustrate, in 1930 petitioner purchased $5,000.00 par value Portland General Electric 4½% bonds at a cost of $4,593.75. During the year ended May 31, 1932, petitioner wrote down the value of said bonds $2,143.75 or down to $2,450.00. Thereafter, in the year ended December 31, 1933, petitioner further wrote down said bonds $550.00 or from $2,450.00 to $1,900.00. Petitioner received no tax benefit from the aforesaid write-downs because in said years it had losses ot $147,005.57 and $35,494.73, respectively. In 1939 petitioner sold said bonds for $4,062.50 at an actual loss of $531.25 which is the difference between $4,593.75, the cost, and $4,062,50, the sale price, of said bonds. However, it reported a profit of $2,162.50 which is the difference between the sales price and written-down basis of $1,900.00. Through this sale the petitioner recovered $2,162.50 of its total write-downs of $2,693.75, for which write-downs it received no tax benefit in the years when written down because in said years petitioner had losses.

The District Court found that the bonds to the extent of the charge-offs were bad debts, and that although not reported in the column provided for bad debts on the tax return, the petitioner claimed a bad debt deduction for the bond write-downs for which it received no tax benefit and that a recovery of such bad debt did not constitute taxable income (R. 39, 40). On appeal, the Court of Appeals reversed the lower court and held the entire amount recovered by the petitioner constituted taxable income for the reason that the write-downs of bonds were not bad debts (R. 59) and that Sec. 22(b) (12) of the Internal Revenue Code is limited to the specific statutory exclusions therein enumerated (R. 60).

REASONS FOR ALLOWANCE OF WRIT OF CERTIORARI.

I. The Court of Appeals in deciding that recoveries realized by the petitioner in 1939 of bad debt charge-offs of bonds in prior years when the petitioners' taxable income was a deficit and, accordingly, when such charge-offs did not accomplish a reduction in petitioner's tax liability constitute income has decided a question of Federal Income Tax law in a way that is contrary to Section 22(b) (12) of the Internal Revenue Code as interpreted by the applicable decisions of this Court.

II. The decision of the Court of Appeals that the charge-off of bonds taken by the taxpayer did not represent bad debts is a matter of tax accounting and not of law and the finding of the District Court is conclusive.

III. By the Court of Appeals' strict construction of Section 22(b) (12) of the Internal Revenue Code, the Court has failed to carry out the relief purposes of Congress and the Court's decision is in conflict with the decision of other Courts of Appeal.

Wherefore, your petitioner respectfully prays that a writ of certiorari issue to the United States Court of Appeals for the Seventh Circuit and submits its brief hereto attached in support of this petition.

Respectfully submitted,

LUCIEN L. DUNBAR,
925 Circle Tower,
Indianapolis, Indiana,

MERLIN M. DUNBAR,
925 Circle Tower,
Indianapolis, Indiana,
Counsel for Petitioner.

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BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

I.

SUMMARY OF ARGUMENT

Where Petitioner Had Written Down Its Bonds and Made Charge-Offs Therefor On Its Books and Taken Deductions in Loss Years Without Receiving Any Tax Benefit, and Later Made Recoveries, Petitioner Has the Right to Exclude Such Recoveries From Its Taxable Income.

The United States Supreme Court has held that no statute or regulation having the force of one and no principle of law compels a Court to find taxable income in a transaction where, as a matter of fact, it found no economic gain and no use of the transaction to gain tax benefit.

II.

Findings of Fact of District Court Are Conclusive.

The special findings of fact by the District Court are conclusive if supported by any evidence whatever, and the only question is whether the conclusions of law were warranted by the facts found. The evidence amply supports the findings of facts.

III.

The Courts Have, Without Exception Given a Broad Construction of Section 22(b) (12) in Order to Provide the Relief Intended by Congress.

The Supreme Court, in discussing the purpose of this Section, led the way for a liberal interpretation by saying that Congress would hardly expect the Courts to repeat the same error (referring to relief in bad debt cases) in another class of cases in which the Court extended the application of the statute.

ARGUMENT.

I.

The Court of Appeals in Deciding That Recoveries Realized by the Petitioner in 1939 of Bad Debt Charge-Offs of Bonds in Prior Years When the Petitioner's Taxable Income Was a Deficit and, Accordingly, When Such Charge-Offs Did Not Accomplish a Reduction in Petitioner's Tax Liability Constitute Income Has Decided a Question of Federal Income Tax Law in a Way That Is Contrary to Section 22(b)(12) of the Internal Revenue Code As Interpreted By the Applicable Decisions of This Court.

The Court of Appeals for the Seventh Circuit concluded (C.C.A., R. 57) that the bad debt recoveries here involved were income when received. The Court cited no direct authority for this proposition, and the petitioner asserts that it is contrary to the law and facts applicable to the recoveries. Futhermore, the Court has arbitrarily discriminated against the petitioner—a bank—and placed it in a separate classification from other banks.

The facts are clear, and are supported by a stipulation of facts (R. 32, 37) and the uncontradicted testimony of one witness (R. 16, 24). The petitioner, prior to 1937, purchased twenty-two different issues of corporate, municipal and governmental bonds for which it took bad-debt charge-offs for the years 1932, 1933 and 1937 (R. 37). Had the petitioner not claimed such bad-debt charge-offs in its 1932, 1933 and 1937 Federal income tax returns, such returns, nevertheless, would have disclosed sizeable losses (R. 35). Futhermore, the total sales price of twelve issues of the bonds plus the amount recovered in 1939 on such bonds was

less than the original cost to the petitoner (R. 37). The remaining ten issues of bonds were fortunately sold at a price in excess of the original cost, so that the petitioner recouped not only its bad-debt charge-offs but realized a small profit (R. 37).

Up to 1938 it was a common practice for all taxpayers to take partial bad-debt charge-offs of bonds as well as notes. *Commonwealth Commercial Bank v. Lucas,* 41 Fed. (2d) 111. Thereafter, banks alone were permitted to make such charge-offs of bonds (Section 23 (k) Revenue Act of 1938) infra. In the case of banks, the charge-offs, whether they be of notes or bonds, are made at the request of the State or Federal Banking authorities. *Corn Exchange National Bank & Trust Company,* 46 B.T.A. 1107—Appeal dismissed (1944) (C.C.A. 3). In the present case, the Indiana Department of Financial Institutions directed the charge-off of the bonds herein involved. The Tax Court of the United States (formerly the U. S. Board of Tax Appeals) has, since 1941 treated the recoveries of bad debt charge-offs of bonds as non-taxable where no prior tax benefit had been received. *Bank of Newberry,* 1 T. C. 374, Acquiesced by Commissioner 1943. There have also been numerous memorandum decisions handed down by the Tax Court which are not officially reported. The Commissioner of Internal Revenue had not seen fit to appeal these cases, with one exception, which case was later dismissed before the Court of Appeals for the Fifth Circuit.

Prior to the enact of Section 22(b) (12) the Courts were more and more accepting the principle that if the amounts previously deducted for losses, expenses, bad debts, taxes, etc. did not effect an offset of taxable income for the year in which deducted, their recovery in subsequent years did not constitute gross income. In the case of *The National*

Bank of Commerce of Seattle v. Commissioner of Internal Revenue, 40 B. T. A. 72 at page 76, decided June 9, 1939, the Board very aptly stated:

> "Therefore, regardless of whether the debts were charged off, in the instant proceeding, on the bank's own initiative or on the order of a bank examiner, if the charge-offs accomplished no reduction in tax liability in the year in which they were charged off, the recoveries of such debts in a subsequent year would not constitute income in the year of their recovery."

As to how far the codification of the rule of recoveries should be extended was answered by this Court in the case of *Dobson v. Commissioner,* 320 U. S. 489, 64 S. Ct. 239, at page 505:

> "Courts were persuaded to rule as matter of law that bad debt recoveries constitute taxable income, regardless of tax benefit from the charge-off. The Tax Court had first made a similar holding, but had come to hold to the contrary. Substitution of the courts' rule for that of the Tax Court led to such hardships and inequities that the Treasury appealed to Congress to extend relief. It did so. *The Government now argues that by extending legislative relief in bad debt cases Congress recognized that in the absence of specific exemption recoveries are taxable as income. We do not find that significant in the amendment.* A specific statutory exception was necessary in bad debt cases only because the courts reversed the Tax Court and established as matter of law a 'theoretically proper' rule which distorted the taxpayer's income. *Congress would hardly expect the courts to repeat the same error in an-*

other class of cases, as we would do were we to affirm this case.

"The Government also suggests that 'If the tax benefit rule were judicially adopted the question would then arise of how it should be determined,' and the difficulties of determining tax benefits, it says, create 'an objection in itself to an attempt to adopt such rule by judicial action.' We are not adopting any rule of tax benefits. *We only hold that no statute or regulation having the force of one and no principle of law compels the Tax Court to find taxable income in a transaction where as a matter of fact it found no economic gain and no use of the transaction to gain tax benefit.* The error of the court below consisted of treating as a rule of law what we think is only a question of proper tax accounting." (Italics ours.)

Immediately after the Dobson decision, the Treasury Regulatoins were amended to enlarge upon the three items of recovery exclusion set out in Section 22(b) (12) of the Internal Revenue Code as added by the Revenue Act of 1942, as follows:

"See *Dobson v. Commissioner,* 64 S. Ct. 239. The term 'recovery exclusion' as used in these regulations means accordingly an amount equal to the portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in Section 22(b) (12) and of *all other items subject to the rule of exclusion* which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer * * * " (Italics ours.) Treasury Regulations 111, Section 29.22(b) (12)-1, infra.

The Court of Appeals very adroitly found, contrary to the findings of the District Court, that the petitioner did not take a bad debt deduction, and, therefore, Section 22(b)

(12) was inapplicable. The Dobson case was cast aside by the Court of Appeals on the grounds that Section 22(b) (12), as added by the Revenue Act of 1942 vitiated the effect of such decision, not realizing that the Supreme Court was well aware of the amendment made by Congress in 1942. In fact, the Supreme Court in disposing of the Government argument in the Dobson case that Section 22(b) (12) of the Internal Revenue Code was controlling said *"Congress would hardly expect the courts to repeat the same error in another class of cases, as we would do were we to affirm in this case."*

In *Dobson v. Commissioner,* supra, the Commissioner was attempting to tax a recovery from a stock loss deducted by the taxpayer in prior years on the theory that taxpayer's adjusted cost was zero, just as in this case the Court of Appeals decided that the petitioner's basis is the last inventory value . At this point, it suffices to say that even the Court of Appeals recognized that the petitioner received no tax benefit from its charge-offs. The petitioner is not asking for a windfall but does believe it should be accorded the same treatment as other banks.

II.

The Decision of the Court of Appeals That the Charge-Off of Bonds Taken By the Taxpayer Did Not Represent Bad Debts Is a Matter of Tax Accounting and Not of Law and the Finding of the District Court Is Conclusive.

The Court of Appeals reversed the finding of the District Court that the bonds were bad debts to the extent to which they were written down for the reasons that (1) the write-downs were not reported as 'bad debts" in the tax

returns, and (2) that the taxpayer, having followed the inventory method of reporting, the write-downs lost their character of bad debts.

Irrespective of the method of reporting, a bond is always a debt and cannot lose its character as such by any action taken by its owner. It is not relevant that the deduction for bad debts was not claimed under such heading on its tax return. The District Court was quick to realize that it was not the form but substance that controlled. The Court is supported by the case of *Houbigant, Inc. v. Commissioner,* 31 B. T. A. 954, affirmed per curiam C.C.A. 80 F. (2d) 1012, certiorari denied, 298 U. S. 669. There, customs duties were included under the cost of goods sold in the taxpayer's returns and no deduction was taken under the item "Taxes Paid." The taxpayer contended that it had received no deduction for "Taxes Paid" because it did not list the same under the item "Taxes Paid." The Board, in disposing of this argument, said:

> "The facts in this case show that in the income tax returns filed by the petitioner for the year 1924 to 1930, inclusive, the petitioner *claimed* and was *allowed* the deduction of the full amounts of the customs duties paid. They were not allowed under the name of customs duties, but in increased cost of goods purchased by the petitioner."

So, in effect, taxes were claimed and allowed even though not deducted specifically under the proper item of the tax returns.

Neither the law nor the Treasury Regulations makes any provision as to how a deduction for a bad debt is to be made. The question always is as to whether a deduction was claimed and allowed in a prior loss year, and not as to

the method used to show the deduction on the tax return. Before there can be a reduction in taxpayer's income there must first be a charge-off on the taxpayer's books, which was done by this petitioner.

Since a bond is as much the obligation and indebtedness, as the note or open account, of the debtor, bonds have been treated as debts under all revenue statutes, and the Treasury Regulations have consistently provided for deductions of charge-offs of bonds, in whole or in part, as bad debts. *Commonwealth Commercial Bank v. Lucas* (Court of Appeals, District of Columbia), 41 Fed. (2d) 111. However, since the enactment of the Revenue Act of 1938, banks alone are permitted to charge off, in whole or in part, as bad debts, bonds or other evidences of indebtedness (including those issued by a government or political subdivision thereof) with interest coupons or in registered form. (Section 23(k), Revenue Act of 1938), infra.

Under Section 23(j) of the Revenue Acts of 1932 and 1936, petitioner was permitted to take partial bad-debt charge-offs, and did take such charge-offs by writing down its securities and charging such write-downs to its undivided profits account. (R. 21, 23.) There is nothing unusual about the aforesaid method used by the petitioner. This is the customary, usual and ordinary way for any taxpayer to take a bad-debt charge-off on its books and records. The petitioner operated under the direction of the Indiana Department of Financial Institutions and made its write-downs and charge-offs under the direction of such authorities. (R. 25, 26.) The taxpayer received no tax benefit from its action, since it would have owed no tax had such write-downs and charge-offs not been made. The treatment of the bonds herein involved by the petitioner was well known to the Commissioner of Internal Revenue

through his examination of petitioner's tax returns. Such treatment was accepted by the Commissioner in the final determination of petitioner's income tax liability over the years, particularly the years 1932, 1933 and 1937. (R. 34, 35.) The evidence shows that there was no adjustment of inventory (since the petitioner kept no inventory on its books) to effect charge-offs. To the contrary, the charge-offs were made on the petitioner's books themselves as to each individual security (R. 21, 23) in the regular manner for any taxpayer to take a bad-debt charge-off. All that petitioner did, from which the Court of Appeals gets its false impression, was to use an inventory of its securities in filing its income tax returns. This method affected petitioner's gross profit but no differently than had petitioner refrained from using an inventory of its securities and taken the write-downs under the item "Bad Debts" on the tax returns.

The special findings of facts of the District Court are conclusive, and the only question is whether the conclusions of law were warranted by the facts found.

The Supreme Court in *McCaughn v. Real Estate Land Title and Trust Company*, 297 U. S. 606, 56 S. Ct. 604, reversed the judgment of the Circuit Court of Appeals and affirmed the judgment of the District Court which had decided the issue against the taxpayer. Within two years prior to his death, the decedent transferred a substantial part of his estate to a trust for the benefit of his children. The District Court held the trust subject to estate tax on the grounds that the estate had failed to show that the motive which induced the transfer was not of the sort which leads to testamentary disposition of property. The Circuit Court reviewed the evidence and reversed the judgment.

The Supreme Court in its decision said on page 608:

> "Where a general verdict is found by the trial court, it has the same effect as the verdict of a jury. The Appellate Court cannot pass upon the weight of evidence. * * * Here, plaintiff's exceptions to the conclusions of law of the trial court, and to the refusal of the court to reach other conclusions as requested, raised no question save the one of law, whether the court's verdict *was wholly without evidence to sustain it*. The question does not appear to be substantial. The ultimate question for the decision of the trial court was one of fact and its general verdict was conclusive. The Circuit Court of Appeals was without authority to weigh the evidence and to make its own findings." (Italics ours.)

In *United States v. Buffalo Pitts Company*, 234 U. S. 228, 232, 34 S. Ct. 840, 841, the opinion states:

> "In cases brought under this act coming up from a district or circuit court of the United States, the findings of fact of the trial court are conclusive, and the question is whether the conclusions of law were warranted by the facts found. (*Chase v. United States*, 155 U. S. 489, 500, 39 L. ed. 234, 288, 15 Sup. Ct. Rep. 174.) Exceptions to the rule may exist if the record enables the court to conclude that the ultimate facts found are not supported by any evidence whatever. (*Collier v. United States*, 173 U. S. 79, 43 L. ed. 621, 19 Sup. Ct. Rep. 330.)" (234 U. S., p 232.)

The District Court, in its Special Findings of Fact (Finding "B") found "that the bonds listed in Exhibit 2, to the extent which they were written down, were bad debts owed by the corporations, whose bonds they were, to the petitioner; that although not reported as bad debts in the columns provided therefor in the tax returns of the years in question, nevertheless the write-downs represent bad debts and reduced the gross profit and so constituted bad debt

deductions from the taxable income of the plaintiff for those years." The Court could not have found differently. The write-downs in prior years were approved by the Commissioner of Internal Revenue. Such write-downs affected the income of the years involved. The only justification for the approval by the Commissioner of petitioner's action is that the bonds to the extent they were written down were bad debts. Among the allowable deductions permitted by statute there is no other category under which such deductions would have been allowable. The write-downs were both deductible and allowable because by appellee's method the gross profit was reduced to the extent of the write-downs instead of listing said deductions under the item "Bad Debts" of the tax return.

In *Dobson v. Commissioner,* supra, where the Commissioner was attempting to tax a recovery from a loss deducted by the taxpayer in prior years, the Supreme Court made these pertinent remarks: "What, in the circumstances of the case, was a proper adjustment of the basis was purely an accounting problem and therefore a question of fact for the Tax Court to determine." (p. 504.) "The error of the Court below consisted of treating as a rule of law what we think is only a question of proper tax accounting." (p. 506.) What was said in that case is equally applicable here. As to whether the basis to be used by the appellee in determining the loss or gain in the sale or redemption of its securities was actual cost or the written-down value, is purely an accounting problem. The question before the District Court was one of fact and the Court's finding is conclusive.

III.

By the Court of Appeals' Strict Construction of Section 22(b) (12) of the Internal Revenue Code, the Court Has Failed to Carry Out the Relief Purposes of Congress and the Court's Decision Is In Conflict With the Decision of Other Courts of Appeal.

The decision of the Court of Appeals for the Seventh District in this case is in conflict with the conclusion of the Court of Appeals for the Second District in the case of *Central Hanover Bank and Trust Company v. U. S.* (C. C. A. 2) 159 F. (2nd) 865.

In the latter case, the Commissioner of Internal Revenue urged that Section 22(b) (12) of the Internal Revenue Code was inapplicable because the taxpayer, after making the charge-offs, transferred the debts to a wholly owned subsidiary, which several years later retransferred the debts to the taxpayer. The Commissioner contended that each transfer constituted a taxable event which rendered the tax benefit rule inapplicable. The Court found for the taxpayer and based its decision upon the proposition that Section 22(b) (12) of the Internal Revenue Code was written to give relief to taxpayers who would otherwise have to pay tax on bad debt recoveries from the write-offs of which they had received no tax benefit, and that the tax burden of the taxpayer had not been lessened by the transfers.

While it is apparent that the facts involved in the above case are not on all fours with the facts of the instant case, it is submitted that the general problem and rule of law is the same. In neither case did the taxpayer receive any tax benefit from its charge-offs. In the above case the government was contending that a transfer of the debts constituted

a sale and consequently the debts lost their identity as such. Whereas, in the instant case, the Court of Appeals has held that the debts lost their identity because the tax returns were made on an inventory basis.

The charge-offs gave the petitioner no tax benefit, and if the recoveries are taxed, it will suffer a hardship by being taxed with income, where none existed. Petitioner will not receive the same equitable treatment that is accorded banks which did not report on an inventory basis.

The Court of Appeals has reached a conclusion neither consistent with the decision of the Second Circuit in the Central Hanover Bank case, nor with the decision of this Court.

CONCLUSION.

For the reasons stated, your petitioner respectfully prays that a writ of certiorari issue to enable this Court to review the judgment of the Court of Appeals in this case.

Respectfully submitted,

LUCIEN L. DUNBAR,
925 Circle Tower,
Indianapolis, Indiana.

MERLIN M. DUNBAR,
925 Circle Tower,
Indianapolis, Indiana.

Counsel for Petitioner.

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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 794

THE UNION TRUST COMPANY OF INDIANAPOLIS,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The District Court did not write an opinion. Its findings of fact and conclusions of law (R. 31-41) are not officially reported. The opinion of the Court of Appeals (R. 57-61) is reported at 173 F. 2d 54.

JURISDICTION

The judgment of the Court of Appeals was entered on March 2, 1949. (R. 62.) The petition for a writ of certiorari was filed on May 16, 1949. The

jurisdiction of this Court is invoked pursuant to 28 U.S.C., Sec. 1254.

QUESTION PRESENTED

Taxpayer bank, in its capacity as a dealer in securities, kept its books on the inventory basis of accounting. During 1932, 1933 and 1937, loss years, taxpayer wrote down the inventory value of certain securities without any resulting tax benefit. Is taxpayer entitled under Section 22(b)(12) of the Internal Revenue Code to exclude from taxable income recoveries of such write-downs realized in 1939? The answer depends upon whether or not the adjustment of inventory values of securities constitutes a charge-off of "bad debts" arising from "worthlessness or partial worthlessness" of the securities.

STATUTES AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra*, pp. 10-17.

STATEMENT

The facts, as stipulated and found by the District Court (R. 31-40), may be summarized as follows:

The taxpayer is a bank located in Indianapolis, Indiana. As part of its functions during the period in question, taxpayer operated a bond department through which it bought corporate and governmental bonds for the purpose of resale to customers. (R. 32.) Beginning with the taxable year 1921 and up to and including the taxable year 1939, taxpayer with the approval of the Commissioner of Internal Revenue filed its income tax returns with

respect to these securities on the inventory basis. (R. 32.) The inventory was valued at the end of each year at cost or market, whichever was lower. Once the value of a given security was reduced on the inventory set out in the income tax return, the reduced value was thereafter treated as cost. (R. 32-33.) These inventories set out in the tax returns were used in computing the cost of gross sales and gross profits from the sales of securities, but taxpayer during the period in question also kept a security ledger in which it recorded the purchase date, description and the purchase price of each individual security. (R. 33.)

Exhibit 2 to the stipulation of facts (R. 37) lists certain issues of bonds which were part of taxpayer's inventory for income tax purposes. These bonds were acquired prior to 1939 and were sold or redeemed during 1939 at a profit over their inventory value. (R. 34, 37.) In the years 1932, 1933 and 1937 the taxpayer incurred substantial losses which were recorded in its income tax returns. (R. 35.) During these three years the values of certain of the Exhibit 2 bonds were reduced. (R. 37.) The losses incurred by taxpayer during the years in question exceeded its gross inventory reductions or write-downs, and even without the inventory reductions, taxpayer would have incurred no income tax during these years. (R. 35, 37, 40.) In 1939 when it redeemed or sold the bonds listed in Exhibit 2 the amount received therefrom was $34,055.76 more than the latest previous inventory valuation.

(R. 37.) Of this amount $22,335.76 arose from inventory reductions in taxpayer's loss years. Taxpayer claims that the amount of $22,335.76 is excludable from income subject to tax. (R. 37.)

Taxpayer's total payments for 1939 income tax amounted to $21,946.70 plus interest. (R. 33.) By claim for refund filed February 17, 1943, taxpayer claimed $4,454.31 as an overpayment of 1939 on the ground that (R. 7, 13, 33-34):

> Recoveries on bad debts and bonds which were charged off in a tax loss year were included as income and a tax paid thereon.

The Commissioner of Internal Revenue rejected the claim to the extent of $3,730.14. (R. 3, 13, 34.) Thereafter the taxpayer brought this action. (R. 1.)

The District Court found and concluded (R. 39-41) that the reductions in inventory value of the bonds in question were bad debts and that the amounts received for the bonds in 1939, to the extent of inventory reductions in loss years, did not constitute taxable income. Judgment was accordingly entered for the taxpayer in the principal amount of $3,730.14, together with interest and costs. (R. 41.) The Government appealed to the Court of Appeals for the Seventh Circuit which reversed the judgment and ordered that the petition be dismissed. (R. 61-62.)

ARGUMENT

It is clear from the record that the taxpayer purchased and held the securities in question for re-

sale to customers at a profit, rather than for investment. (R. 32.) Hence, for present purposes, it is a merchant of securities. Treasury Regulations 103, Section 19.22(c)-5, Appendix, *infra*. As such, its gross income for tax purposes was properly determined on the inventory basis as the difference between gross sales and the cost of goods sold[1] without "subtractions . . . for depreciation, depletion, selling expenses, or losses, or for items not ordinarily used in computing the cost of goods sold." Treasury Regulations 103, Section 19.22 (a)-5, Appendix, *infra*.

The taxpayer's petition is, however, predicated mainly on the assumption that there is no distinction between its operations as a dealer in securities, in which it properly employed the inventory method of accounting, and its ordinary operations as a bank, in the course of which it was allowed bad-debt deductions arising from the worthlessness or partial worthlessness of promissory notes and other obligations. What the taxpayer is now attempting to do is to bring the transactions in question within the scope of Section 22(b)(12) of the Internal Revenue Code, which provides for the exclusion from income of recoveries in respect of bad debts and certain other items that have been deducted in prior years without tax benefit therefrom.

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[1] The taxpayer's opening inventory, plus the cost of inventoriable items purchased during the year, less the value of the closing inventory, determines the cost of goods sold during the taxable year. See Kester, *Principles of Accounting* (Third Rev. ed., 1930), p. 50.

To achieve this purpose, it seeks to treat the write-downs, under the inventory method of accounting which it had adopted and to which the Commissioner had acceded, of bonds which it acquired for sale to its customers as a writing off of "bad debts." Aside from the fact that the taxpayer itself did not treat these write-downs as bad debts in its returns for the loss years in question, it is plain that they are not "bad debts", within the scope either of Section 22(b)(12) or of any other reasonable definition of that term. Section 22(b)(12)(A) (Appendix, *infra*) defines a "bad debt" as a "debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year." Examination of Exhibit 2 (R. 37) shows that over 40% of the bonds which the taxpayer wrote down for inventory purposes were United States Treasury Bonds, which could not possibly be regarded as worthless or even partially worthless. (R. 60.) Similarly, certain of the bonds in question (e.g., Item 16, Ex. 2, R. 37) were purchased at a premium, which premium was written off in 1937 and partially recovered in 1939. The amount of the debt was at all times the same, and it is obvious that the taxpayer could not in 1937 have deducted the amount of the premium as a "bad debt", even had it attempted to do so.

The foregoing considerations stress the impracticability of attempting to treat the bonds which the petitioner bought and sold in the course of its business as a merchant of securities in the same

manner as notes which it acquired in the course of its regular banking business and which became worthless or partially so because of the insolvency of the debtor.[2] As the Court of Appeals pointed out, the bonds in question, under the system of accounting which the petitioner adopted for tax purposes and which was appropriate to its business, "lost their individual identity in the general inventory." (R. 60.) Under the inventory method, in other words, the bonds in question have lost their character as debts and, for present purposes, are considered as so much merchandise for sale to customers. The taxpayer's effort to itemize and trace them through prior years is no more appropriate than it would be in the case of drygoods or hardware. Cf. *Lucas* v. *Structural Steel Company,* 281 U. S. 264, 269; *Burroughs Adding Machine Co.* v. *Commissioner,* 9 B.T.A. 938, 943.

The taxpayer relies chiefly upon *Dobson* v. *Commissioner,* 320 U. S. 489, which the court below considered carefully and found inapplicable. (R. 61.) The taxpayer in that case was not a dealer in securities, and there was presented no question of departure from a long established method of accounting for tax purposes. The *Dobson* case is certainly not authority for the proposition that Section 22(b)(12) is intended to authorize departure from the basic principle that income

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[2] The taxpayer's claim for refund was allowed to the extent that it was predicated upon recoveries of loans on promissory notes previously charged off without tax benefit. (R. 3, 13, 34.)

taxes are imposed and must be accounted for on a yearly basis. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359. In the *Dobson* case this Court upheld the finding of the Tax Court that, viewing as a whole the transactions out of which the recovery there in question arose, the taxpayer had realized no taxable income; but that case presented no such situation as is here concerned, where the taxpayer was a dealer in securities and used the inventory method of accounting. *Central Hanover Bank & Trust Co.* v. *Commissioner*, 159 F. 2d 865 (C. A. 2), asserted by the petitioner to be in conflict with the instant case, is equally inapplicable, for in that case the taxpayer had actually taken the bad debt deductions in earlier years, and there was no question of revaluing inventories. *Bank of Newberry* v. *Commissioner*, 1 T. C. 374 (Acquiescence, 1943 Cum. Bull. 2), also cited by the taxpayer, is inapplicable for similar reasons. A much more pertinent analogy is *Virginian Hotel Co.* v. *Helvering*, 319 U. S. 523, rehearing denied, 320 U. S. 810, where the taxpayer contended that excessive depreciation taken in prior loss years should be restored to cost basis, insofar as the depreciation had not resulted in tax benefit, for the purpose of computing current deductions. This Court held that the depreciation deduction is not a "guarantee" that investment will be recovered tax-free, and that Congress had not "indicated that a taxpayer who has obtained no tax advantage from a depreciation deduction should be allowed to take it a second time." 319 U. S. at

528. Cf. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359; *New Colonial Co.* v. *Helvering*, 292 U. S. 435; *Douglas* v. *Commissioner*, 322 U. S. 275. The position of the taxpayer in the instant case amounts to an assertion that write-downs because of fluctuations in value of merchandise may be treated as bad debts for tax purposes, and we do not understand such to be the law. Cf. *De Loss* v. *Commissioner*, 28 F. 2d 803 (C.A. 2), certiorari denied, 279 U. S. 840.

CONCLUSION

The decision of the Court of Appeals is correct, there is no conflict, and the petition should be denied.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General;
THERON L. CAUDLE,
Assistant Attorney General;
ELLIS N. SLACK,
LEE A. JACKSON,
L. W. POST,
JOSEPH W. BISHOP, JR.,
Special Assistants to the Attorney General.

JUNE, 1949.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

* * * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * * *

(12) [as added by Sec. 116 of the Revenue Act of 1942, c. 619, 56 Stat. 798].[3] *Recovery of Bad Debts, Prior Taxes, and Delinquency Amounts.* Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purpose of this paragraph:

(A) *Definition of Bad Debt.*—The term "bad debt" means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

* * * * *

(D) *Definition of Recovery Exclusion.*—The term "recovery exclusion," with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner with the

[3] Subsection (c) of Section 116 makes these additions effective as if a part of the Revenue Act of 1938 and prior Revenue Acts.

approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.

* * * * *

(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

(1) *Inventory Value.*—If the property should have been included in the last inventory, the basis shall be the last inventory value thereof:

(26 U.S.C. 1946 ed., Sec. 113.)

Section 113(a)(1) of the Revenue Act of 1932, c. 209, 47 Stat. 169, and Section 113(a)(1) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, contain identical words.

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(j) *Bad Debts.*—Debts ascertained to be worthless and charged off within the taxable year * * * and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

* * * * *

Section 23(k) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, contains identical words.

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22(a)-5. *Gross income from business.*—In the case of a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. In determining the gross income subtractions should not be made for depreciation, depletion, selling expenses, or losses, or for

items not ordinarily used in computing the cost of goods sold. * * *

SEC. 19.22(b)(12)-1 [as added by T. D. 5288, 1943 Cum. Bull. 103, and amended by T. D. 5454, 1945 Cum. Bull. 68]. *Recovery of certain items previously deducted.*—(a) *In general.* Section 22(b)(12) provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. (See *Dobson* v. *Commissioner,* 64 S. Ct. 239.) The term "recovery exclusion" as used in these regulations means accordingly an amount equal to the portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in section 22(b)(12)), and of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under Chapter 1 of the Internal Revenue Code (other than a tax under section 102) or under corresponding provisions of prior revenue laws.

(1) *Section 22(b)(12) items.*—The term "section 22(b)(12) items" as used in these

regulations means those bad debts, prior taxes, delinquency amounts, and all other items subject to the rule of exclusion, for which a deduction or credit was allowed for a prior taxable year. If a bad debt was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts, it was not deducted, and it is therefore not considered a section 22(b)(12) item. * * *

(2) *Definition of "recovery."*—Recoveries result from the receipt of amounts in respect of the previously deducted or credited section 22(b)(12) items, such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued. * * *

* * * * *

SEC. 19.22(c)-1. *Need of inventories.*—In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. * * *

SEC. 19.22(c)-2. *Valuation of inventories.*—Section 22(c) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the

best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income. * * *

* * * * * *

SEC. 19.22(c)-5. *Inventories by dealers in securities.*—A dealer in securities who in his books of account regularly inventories unsold securities on hand either—

(a) At cost;

(b) At cost or market, whichever is lower; or

(c) At market value,

may make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years, unless another method be authorized by the Commissioner pursuant to a written application therefor filed with the Commissioner as provided in section 19.41-2. A dealer in securities in whose books of account

separate computations of the gain or loss from the sale of the various lots of securities sold are made on the basis of the cost of each lot shall be regarded, for the purposes of this section, as regularly inventorying his securities at cost. For the purpose of this rule a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule.

SEC. 19.23(k)-1. *Bad debts.*

* * * * *

(b) If all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing

net income. There should accompany the return a statement showing the propriety of any deduction claimed for bad debts. * * * Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible. Any amount subsequently received on account of a bad debt or on account of a part of such debt previously charged off and allowed as a deduction for income tax purposes, must be included in gross income for the taxable year in which received. In determining whether a debt is worthless in whole or in part the Commissioner will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor. * * *

* * * * *

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